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Taking and Federal Impairment of Contract Issues in the Extension of Preemption of Due-on-Sale Restrictions Beyond Federal Savings and Loans

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Taking and Federal Impairment of Contract Issues in the Extension of Preemption of Due-on-Sale Restrictions Beyond Federal Savings and Loans

Prompted by the need to rid their loan portfolios of long-term, low interest rate mortgage loans, savings and loan associations in the early 1970's began to enforce due-on-sale clauses[1] when borrowers assigned their mortgages. This new use of the clause,[2] which was in response to borrower's new interest in allowing assumptions,[3] was challenged by borrowers as a restraint on alienation. Several states[4] accepted the restraint on alienation argument and adhered to the old use of the clause, allowing lenders to accelerate the loan only when an uncreditworthy individual assumed the mortgage. Reacting to these restrictions on enforcement, the Federal Home Loan Bank Board, which regulates federal savings and loans, promulgated a regulation preempting state law in 1976.[5] Congress, in 1982, extended this preemption to all lenders.[6] A three year grace period was imposed on loans from lenders other than federal savings and loans in states that had restricted enforcement of the clause.

Because savings and loans have been unable to make their loan portfolios fully responsive to shifts in interest rates,[7] the thrifts may look to the due-

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[1] The following is an example of a due-on-sale clause contained in the FNMA/FHLMC Uniform Mortgage Instrument:

> Transfer of Property: Assumption. If all or any part of the Property or an interest therein is sold or transferred by Borrower without Lender's prior written consent, excluding (a) the creation of a lien or encumbrance subordinate to the Mortgage, (b) the creation of a Purchase Money Security interest for household appliances, (c) a transfer by devise, descent, or by operation of law upon the death of a joint tenant or (d) the grant of any leasehold interest of less than three years not containing an opinion to purchase, Lender may, at Lender's option declare all the sums secured by this Mortgage to be immediately due and payable.

Dunn & Nowinski, *Enforcement of Due-On-Transfer Clauses: An Update*, 16 REAL PROP., PROB. & TR. J. 291 (1981), *reprinted in* INDIANA CONTINUING LEGAL EDUCATION FORUM, 1 REAL ESTATE. PRACTICE INDIANA § VII 24, 34 (1982).

[2] Kratovil, *A New Dilemma For Thrift Institutions: Judicial Emasculation of the Due-on-Sale Clause*, 12 J. MAR. J. PRAC. & PROC. 299, 300 (1979) [hereinafter cited as Kratovil].

[3] Bartke and Tagaropulos, *Michigan's Looking Glass World of Due-on-Sale Clauses*, 24 WAYNE L. REV. 971, 979-82 (1978) [hereinafter cited as Bartke].

[4] Arizona, Arkansas, California, Colorado, Florida, Georgia, Illinois, Michigan, Minnesota, Mississippi, New Mexico, New York and Utah. S. REP. NO. 536, 97th Cong., 2nd Sess. 22 nn.2-3 *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 3054, 3076 nn.2-3 [hereinafter cited as History].

[5] 12 C.F.R. §§ 545.8-3(f), (g) (1983).

[6] Garn-St.Germain Depository Institutions Act of 1982, 12 U.S.C. § 1701j-3 (1982).

[7] Many of the variable rate mortgages issued during the 1970s contained self-imposed or regulated restrictions on the amount and frequency of rate increases. Cassidy, *Monte Carlo*

on-sale clause of mortgages made before the congressional preemption as a method of updating their portfolios.

The extension of preemption to lenders other than federal savings and loans raises several new issues. The effect of the extension of preemption varies with the status of state law at the time of preemption. The history of the due-on-sale controversy will be reviewed to identify both the expectations of the parties and the new issues. The issues will be categorized by the type of lender and the status of state law at the time of preemption. Common to all affected loans are the issues of whether the mortgage contracts have been impaired[8] or whether the property of the mortgagors has been taken.[9]

This note examines the impairment and takings issues which are most clearly present in loans made by lenders other than federal savings and loans in states that had restricted use of the clause. After describing the test developed by the Supreme Court in its revival of the contract clause, this note uses the test to examine the federal impairment of contract issue. Finally, the extension of preemption is examined under the takings clause.

THE BACKGROUND OF THE DUE-ON-SALE CONTROVERSY

Due-on-sale clauses, which give the lender the right to accelerate the loan upon transfer of the property, began to be included in mortgage instruments after the Great Depression to assure lenders that the mortgaged real estate would be sold only to another creditworthy buyer.[10] Until interest rates began to rise dramatically in the late 1960's and early 1970's, the sole function of the clause was to protect the security of the lender.[11]

Because interest rates were stable during the period following World War II until 1965,[12] neither borrowers nor lenders were concerned with the question of assumption of the mortgages, so long as the security position of the lender was not affected.[13] Buyers and sellers preferred refinancing to assignment because the seller received cash and the buyer was able to make a smaller down payment.[14] Lenders, therefore, anticipated that the

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Simulation Estimates of the Expected Value of the Due-on-Sale Clause in Home Mortgages, HOUSING FIN. REV., Jan., 1983, at 34-35.

[8] Federal impairment of contract is reviewed under the due process clause. U.S. CONST. amend. V, § 4.

[9] "Nor shall private property be taken for public use, without just compensation." U.S. CONST. amend. V, § 5.

[10] Kratovil, *supra* note 2, at 299-300.

[11] *Id.*

[12] Bartke, *supra* note 3, at 974-78.

[13] OFFICE OF POLICY DEV. & RESEARCH, U.S. DEP'T. OF HOUSING & URBAN DEV., AN ECONOMIC ANALYSIS OF DUE-ON-SALE CLAUSES 3 (1981) [hereinafter cited as ECONOMIC ANALYSIS]; Bartke, *supra* note 3, at 977.

[14] Bartke, *supra* note 3, at 977 n.17.

loans would be paid in a period substantially shorter than the length of the loan.[15]

When interest rate stability ended, methods of home financing changed.[16] New home buyers became interested in assuming lower rate mortgages because of the differential between rates for new and old mortgages.[17] Homeowners profited from assumption because the new buyers were willing to pay a higher price for the home to be able to assume the below market rate.[18] Further, the homeowner gained a competitive advantage in the market by allowing the buyer to assume.[19] By selling on contract, the homeowner could collect the difference between the mortgage rate of interest and the current market rate.[20]

Lenders began to put the clauses to the new use of increasing portfolio yield in response to liquidity problems caused by the increase in interest rates.[21] As interest rates climbed, depositors began to withdraw their money from the savings and loans to take advantage of the higher rates offered by other forms of investment.[22] The withdrawals decreased the available funds, and savings and loans were unable to make mortgage loans.[23]

The thrifts fought the loss of deposits by offering higher interest rates on shorter term savings accounts.[24] Because their primary investment was in twenty-year or longer mortgages which were made when interest rates were much lower, savings and loans experienced an unprofitable spread between the interest rates offered depositors and the rate of return on the old mortgages.[25] The thrifts, who made the long term loans with the expectation that the loans would be repaid in a period substantially shorter than the term of the loan,[26] were unable to turn over the mortgage loans fast enough to keep up with current rates.[27] Faced with lost depositors and profit

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[15] ECONOMIC ANALYSIS, *supra* note 13, at 7.

[16] *Id.* at 3-9.

[17] *Id.*

[18] *Id.*

[19] Bartke, *supra* note 3, at 981.

[20] *Id.* at 982.

[21] Kratovil, *supra* note 2, at 300; Bartke, *supra* note 3, at 979.

[22] Kratovil, *supra* note 2, at 300. The phenomenon is known as disintermediation. "Disintermediation is simply that point in time when interest rates, particularly interest rates on government securities, rise to a point where money flows out of savings institutions [and into government securities] thereby preventing such institutions from making mortgage loans." *Id.* at 300 n.2 (quoting Dall, *The Conventional Mortgage-Backed Security*, *in* FNMA-FHLMC GENERAL COUNSELS' CONFERENCE 159-60 (1978)).

[23] Bartke, *supra* note 3, at 977-79.

[24] Note, *A Case for Preemption:* Wellenkamp v. Bank of America *is Inapplicable to Federal Savings and Loan Associations*, 20 SANTA CLARA L. REV. 219, 236 (1980).

[25] *Id.*; Bartke, *supra* note 3, at 978; ECONOMIC ANALYSIS, *supra* note 13, at 8-9; Dietrich, Langtieg, Dale-Johnson & Campbell, *The Economic Effects of Due-on-Sale Clause Invalidation*, HOUSING FIN. REV., Jan., 1983, at 25-26 [hereinafter cited as Dietrich].

[26] ECONOMIC ANALYSIS, *supra* note 13, at 7.

[27] Note, *supra* note 24, at 236.

squeeze and burdened by loan portfolios that they were unable to roll over, the thrifts began invoking the due-on-sale clause to increase earnings by forcing refinancing at higher, current mortgage rates.[28]

The new use of the clause occurred during a period of consumer suits against the practices of financial institutions.[29] Mortgagors, faced with losses of profits, competitive sales advantage, and the option of selling on contract, challenged the new use as a restraint on alienation, as an usurpation of an ownership right, and as an unconscionable overreaching by the lenders.[30]

An invalid restraint on alienation is an unreasonable restraint on the ability to sell property.[31] Borrowers argued that the new use of the due-on-sale clause was an unreasonable restraint on alienation because it virtually prevented sales of property with assumed mortgages.[32] Courts that accepted the borrower's reasoning found that the lender's desire to increase portfolio yield was not the original purpose of the clause and was an insufficient reason for invoking the clause. These courts placed on the lenders the burden of proving that their security was impaired by the transfer.[33]

The usurpation of an ownership right theory also was drawn from equitable principles. Equity has consistently found that mortgagors retain all the essential rights of ownership while mortgagees hold only a security interest in the property.[34] The mortgagor holds the right to devise, convey or encumber the property, subject only to the lien interest of the mortgagee.[35] The mortgagee's only right in the property is that the collateral not be impaired.[36] The mortgagee can not foreclose for any technical violation of a term in the mortgage agreement if the security is not jeopardized.[37] When courts allowed the new use, lenders gained a new right: the option of accelerating when a transfer was made to a creditworthy buyer.[38]

Appealing to the equitable conscience of the courts, borrowers argued that the foreclosures caused by acceleration acted as a penalty and a

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[28] Bartke, *supra* note 3, at 979; Kratovil, *supra* note 2, at 300.

[29] Fraser and McMurry, *The Bank Board's Preemption Decision: Its Origins and Consequences*, 48 LEGAL BULL. 190, 191 (1982).

[30] *See generally id.* (which discussed the equitable defenses to acceleration under the new use); Annot., 69 A.L.R.3d 713 (1976).

[31] Note, *Mortgages - A Catalogue and Critique on the Role of Equity in the Enforcement of Modern-Day "Due-on-Sale" Clauses*, 26 ARK. L. REV. 485, 490 (1973).

[32] Bartke, *supra* note 3, at 990; Kratovil, *supra* note 2, at 300; Note, *Judicial Treatment of the Due-on-Sale Clause: The Case for Adopting Standards of Reasonableness and Unconscionability*, 27 STAN. L. REV. 1109, 1113 (1975).

[33] Bartke, *supra* note 3, at 990.

[34] Note, *supra* note 31, at 489-90.

[35] *Id.*

[36] *Id.*

[37] *Id.*

[38] *See* Note, *supra* note 32, at 1116-17.

forfeiture which is contrary to equitable precepts.[39] Further, borrowers argued that the due-on-sale clause was misleading because it does not put the borrower on notice that the bank has specifically reserved the right to raise the interest charge to the market rate upon transfer.[40] The borrowers also argued that the mortgage was an adhesion contract.[41] Because the borrowers were rarely in a position to bargain with the lenders, who also were more experienced and sophisticated, the lenders could impose their terms.[42]

Lenders, under a freedom of contract theory, argued that the clauses were as presumptively valid as any other contractual agreements between the parties.[43] They further argued that their security in the property was enhanced by the continued ownership of the original borrower whom they knew and had screened.[44] Invoking the clauses was reasonable, therefore, because it protected the lender's security interest.[45]

Courts responded by assigning the burden of proof to the party whose argument was disfavored by the court. Courts which were swayed by the ownership and fairness arguments of the borrowers limited the use of the clause to protection of the lender's security and placed the burden of proving an impairment of security on the lender.[46] Courts which found the use reasonable implicity reasoned that there was a rebuttable presumption that a change in ownership increases the risks of the lender.[47] Other courts forthrightly held that the lender's desire to increase the rate of return on its mortgage portfolio was a sufficient justification for the enforcement of the clause.[48] Under either of these approaches which favored lenders, enforcement of the clause was subject to the equitable defenses of fraud, duress, misrepresentation or overreaching by the lender.[49] The borrower had the burden of affirmatively pleading and proving these defenses.[50]

The controversy was not limited to the courts. Several states passed statutes limiting the use of the clause to the security purpose and limiting fees charged on transfer or increases in the interest rate.[51] California re-

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39 Note, *supra* note 31, at 491.
40 Note, *supra* note 32, at 1124-25.
41 *Id.* at 1124.
42 *Id.*
43 Bartke, *supra* note 3, at 985-86.
44 *Id.*
45 *Id.*
46 *Id.* at 992-93.
47 *Id.* at 985-86.
48 *Id.* at 987.
49 *Id.* at 988.
50 *Id.*
51 The following states have adopted laws restricting enforcement of due-on-sale clauses: Colorado, in 1975, COLO. REV. STAT. § 38-30-165 (1973); Iowa, in 1979, IOWA CODE ANN. § 535.8 (West Supp. 1983-1984); New Mexico, in 1979, N.M. STAT ANN. §§ 48-7-11 to -14 (Supp. 1982); Utah, in 1981, UTAH CODE ANN. §§ 57-15-1 to -10 (Supp. 1981); and Georgia, in 1979, GA. CODE

quired the clause to appear both in the note and the mortgage.[52]

Responding to the adverse court decisions and statutes, the Federal Home Loan Bank Board, which regulates federally chartered savings and loans, promulgated a regulation explicitly preempting state law in 1976.[53] In the preamble to the regulation, the Board explained its intent that the due-on-sale practices of federal savings and loans be governed "exclusively by Federal law."[54] To insure the "[f]ederal associations shall not be bound by or subject to any conflicting state law which imposes different . . . due-on-sale requirements,"[55] the regulation made exercise of the clause a matter "exclusively governed by the contract, . . . [with] all rights and remedies of the association and borrower . . . fixed and governed by that contract."[56]

The focus of the controversy shifted to whether the Board could bring the question of enforceability within its jurisdiction by characterizing enforcement as a lending practice[57] and, if the Board did have authority to regulate enforcement of the clause, whether it had effectively preempted state law.[58] Borrowers argued that the question of whether the clause could be enforced was a matter of state property and mortgage law and not a form of regulation over federal savings and loans.[59] Further, if the Board did have authority to preempt state law, state law was not preempted until 1976 when the Board promulgated the due-on-sale regulation.[60] The Board, however, interpreted a 1948 regulation requiring all loan instruments to provide for full protection to the federal association as authorizing federal savings and loans to exercise due-on-sale provisions because such clauses would help insure full protection to the lender.[61] Preemption, under the Board's theory, therefore, took place in 1948.

Whether the Board's regulation preempted state law was addressed by the Supreme Court in *Fidelity Federal Savings and Loan v. de la Cuesta*,[62] which involved three California loans which had been accelerated after the lender learned of transfer of the secured property. The lender had instituted nonjudicial foreclosure proceedings and the new purchasers filed suit.[63] Two

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ANN. § 44-14-5 (1982). Arizona has limited fees and interest rate increases on the transfer of trust property. ARIZ. REV. STAT. ANN. § 33-806.01 (1974).

[52] CAL. CIV. CODE § 2924.5 (West 1974).

[53] 12 C.F.R. § 545.8-3(f), (g) (1983).

[54] *Id.*

[55] *Id.*

[56] *Id.*

[57] Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 102 S. Ct. 3014, 3023 (1982).

[58] *Id.*

[59] *See id.* at 3020.

[60] Fraser, *supra* note 29, at 191-93.

[61] *Id.* at 193.

[62] 102 S. Ct. 3014 (1982).

[63] *Id.* at 3020. Two of the deeds of trust contained a choice-of-law clause which provided that the deed "shall be governed by the law of the jurisdiction in which the property is located." *Id.* at 3019. The new purchasers challenged both the Board's intent and authority to preempt California law. *de la Cuesta*, 102 S. Ct. at 3014. The intent argument had two grounds. First,

of the deeds were executed before either the Board's 1976 regulation or *Wellenkamp v. Bank of America*,[64] the landmark California case restricting the use of the clause to cases where the security was impaired.[65]

The Court found the Board's authority to preempt in section 5(A) of the Home Owner's Loan Act of 1933 (HOLA).[66]

> In order to provide local mutual thrift institutions in which people may invest their funds and in order to provide for the financing of homes, the Board is authorized, under such rules and regulations as it may prescribe, to provide for the organization, incorporation, examination, *operation*, and *regulation* of associations to be known as "Federal Savings and Loan Association" *or "Federal savings banks"* . . . , and to issue charters therefor, giving primary consideration to the best practice of local mutual thrift and home-financing institutions in the United States.[67]

Endorsing a lower court opinion that "[i]t would have been difficult for Congress to give the Bank Board a broader mandate,"[68] the Court held that "Congress' explicit delegation of jurisdiction over the 'operation' of these institutions must empower the Board to issue regulations governing mortgage loan instruments, for mortgages are a central part of any savings and loan's 'operation.'"[69] By directing the Board, rather than the states, to consider the best practices of local mutual thrift, and home financing institutions[70] Congress intended that the Board develop a uniform system

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the purchasers argued that the Board had not demonstrated the requisite intent to preempt because the Board merely authorized rather than compelled savings and loans to exercise their rights under the clauses. *Id.* at 3023-24. Characterizing the authorization as granting an option, the availability of which the Board considered essential to the economic soundness of the thrift industry, the Court found that California law had been preempted because it "created an obstacle to the accomplishment and execution of the full purposes and objectives of the due-on-sale regulation." *Id.* at 3024.

The purchasers' second argument was based on the second sentence of the regulation. "[E]xercise by the association of such option (hereafter called a due-on-sale clause) shall be exclusively governed by the terms of the loan contract, and all rights and remedies of the association and borrower shall be fixed and governed by that contract." *Id.* (quoting 12 C.F.R. § 545.8-3(f) (1982)). The purchaser's interpreted this language as incorporating state contract law, including state law restricting enforcement of due-on-sale clauses. *Id.*

Noting that the incorporation of state law does not exclude federal law because "the Constitution, laws, and treaties of the United States are as much a part of the law of every State as its own local laws and Constitution," *id.*, the Court found explicit intent to displace state law in the preamble of the regulation. *Id.* at 3024-25.

[64] 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr 379 (1978).

[65] Two earlier California cases restricting the use of due-on-sale clauses had permitted unrestricted exercise in cases of outright transfer of security. LaSala v. American Sav. & Loan Ass'n, 5 Cal. 3d 864, 489 P2d 1113, 97 Cal. Rptr. 849 (1971) (further encumbrance); Tucker v. Lassen Sav. & Loan Ass'n, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974). *See de la Cuesta*, 102 S. Ct. at 3031 n.24.

[66] 48 Stat. 128 (codified as amended at 12 U.S.C. §§ 1461-1470 (1982)).

[67] 12 U.S.C. § 1464(a) (1982) (emphasis theirs).

[68] *de la Cuesta*, 102 S. Ct. at 3026.

[69] *Id.*

[70] *Id.*

of savings and loans[71] capable of remaining financially sound.[72] The Court held that the Board unquestionably had jurisdiction over the associations' lending practices,[73] had extensively regulated those practices, and specifically, had regulated the terms of the loan instruments.[74] Because the Court viewed the due-on-sale regulation as a regulation of mortgage lending practices,[75] it held that the regulation was a reasonable exercise of the Board's authority to ensure the financial stability of the savings and loans.[76]

Several issues were left open by the *de la Cuesta* opinion,[77] principally the pre-regulation loan problem. The purchasers had argued that the regulation was not applicable to the two deeds executed before 1976 because to do so would have destroyed vested rights.[78] The Court, in a footnote, avoided the issue by noting that California law permitted the unrestricted exercise of due-on-sale clauses when the deeds were executed.[79] Because *Wellenkamp* was decided two years after the Board's regulation, it was inapplicable to federal savings and loans.[80] The plaintiffs, therefore, did not have vested rights.[81]

Congress responded to the *de la Cuesta* decision by enacting the Garn-St.Germain Depository Institutions Act (Act),[82] which extended preemp-

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[71] *Id.* at 3028-29.
[72] *Id.* at 3029-30.
[73] *Id.* at 3029.
[74] *Id.* at n.20.
[75] *Id.* at 3030.
[76] *Id.*
[77] The issues include: (1)whether federal associations which reserved the right to accelerate rather than challenge transfers in court may accelerate; (2)whether a state institution which converts to a federal charter may accelerate loans made before the conversion; (3)whether loans originated by a federal savings and loan but since transferred may be accelerated; (4)whether loans originated by nonfederal association lenders but now held by a federal association may be accelerated; (5)whether state statutes giving state chartered institutions the same rights, powers and privileges of federally chartered institutions override state law restricting enforcement; (6)whether the Comptroller of the Currency and the National Credit Union Administration had the authority to preempt restrictive state law. Fraser, *supra* note 29, at 201-03.
[78] *de la Cuesta*, 102 S. Ct. at 3031 n.24. The federal thrifts had developed three arguments against the vested rights theory. First, they argued that the Home Owner's Loan Act itself preempted state law. Second, relying on a 1948 regulation which requires all loan instruments to provide for full protection to the federal association, the associations argued that the 1976 regulation merely affirmed prior Bank Board regulatory authorization of use of due-on-sale clauses. Last, they argued that the vested rights were the product of a legal fiction that state appellate courts do not change the law when they overrule existing authority but, rather, simply decide what the law had always been. The associations urged the Court to disregard the fiction. Fraser, *supra* note 29, at 199.
[79] *de la Cuesta*, 102 S. Ct. at 3031 n.24.
[80] *Id.*
[81] *Id.*
[82] U.S.C. § 1701j-3 (1982). In October of 1981, legislation to preempt state law restricting use of due-on-sale clause was introduced in both houses of Congress. S. 1720, 97th Cong., 1st. Sess., 128 CONG. REC. 11257 (1981); H.R. 4724, 97th Cong., 1st Sess. (1981). Both versions eliminated equitable arguments that a non-security use was a usurpation of an ownership right, *see supra* text accompanying notes 31-42, a restraint on alienation, *see supra* text ac-

tion beyond federal savings and loans and reflected some concern with vested rights. Coverage was extended to include any person or government agency making a real property loan, or any assignee or transferee of such a person or a government agency.[83]

Concern with vested rights prompted Congress to delay preemption for some loans. The Act provides a three-year grace period for loans that were made in a state which had restricted use of the clauses, by constitutional provision, statute or judicial decision having statewide application,[84] were

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companying notes 30-32, or unconscionable overreaching, *see supra* text accompanying notes 41-42. The rights of the parties were fixed by the contracts. S. 1720, 97th Cong., 1st Sess. § 141(f)(1), 128 CONG. REC. 11257 (1981); H.R. 4724, 97th Cong., 1st Sess. § 301(f) (1981). The Federal Home Loan Bank Board was given authority both to issue rules and regulations interpreting the Act, S. 1720, 97th Cong., 1st Sess. § 142(g)(1), 128 CONG. REC. 11257 (1981); H.R. 4724, 97th Cong., 1st Sess. § 302(g)(1) (1981), and to require lenders to observe consumer safeguards. S. 1720, 97th Cong., 1st Sess., 128 CONG. REC. 11257 (1981); H.R. 4724, 97th Cong., 1st Sess. § 301(f) (1981).

The scope of the preemption differed between the two bills. Under the House version, preemption was limited to loans originated or held by federally chartered savings and loans, banks and credit unions. H.R. 4724, 97th Cong., 1st Sess. § 301(f) (1981). The scope of the Senate version is unclear. Preemption was to apply to loans made by depository institutions or lenders who participated in the federal mortgage insurance programs. S. 1720, 97th Cong., 1st Sess. § 141(f)(1) (1981). An earlier section of the Code, which S. 1720 amended, defined depository institution as a federally insured lender.

> (2)(A)The provisions of the constitution or law of any State expressly limiting the rate or amount of interest which may be charged, taken, received, or reserved shall not apply to any deposit or account held by, or other obligation of a depository institution. For purposes of this paragraph, the term "depository institution" means—
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> (i)any insured bank as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. § 1813);
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> (ii)any mutual savings bank as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. § 1813);
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> (iii)any savings bank as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. § 1813);
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> (iv)any insured credit union as defined in section 101 of the Federal Credit Union Act (12 U.S.C. § 1752);
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> (v)any member as defined in section 2 of the Federal Home Loan Bank Act (12 U.S.C. § 1422); and
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> (vi)any insured institution as defined in section 408 of the National Housing Act (12 U.S.C. § 1730a).

Pub. L. No. 96-221, title V, § 501(a)(2)(A) (12 U.S.C. § 1735f-7 (1976)).

Because state chartered institutions commonly are insured by the FDIC or FSLIC, this provision, along with the inclusion of participants in the insured mortgage program, gave the Senate version a much broader scope.

The Senate, unlike the House, included an opt-out provision in its bill. S. 1720, 97th Cong. 1st Sess. § 141(f)(2), 128 CONG. REC. 11257 (1981). The states were given three years to override the preemption by statute or referendum.

[83] *Id.* § (a)(2). Congress intended coverage to include: "individuals, state and federally chartered savings and loan associations, mutual savings banks, state chartered banks, national banks, mortgage bankers and other HUD approved lenders, manufactured home retailers which extend credit, finance companies which make real property loans, agencies of the federal government . . . and transferees . . . of any of them." History, *supra* note 4, at 56-7, U.S. CODE CONG. & AD. NEWS at 3110-11.

[84] 12 U.S.C. § 1701j-3(c)(1) (1982).

made by a lender which was not a federally chartered savings and loan,[85] and were made during the period after the state had restricted use but before passage of the Act,[86] (window period loans).[87]

The states and two federal agencies were given authority to lengthen or shorten the grace period for window period loans.[88] The authorities may otherwise regulate the loans, for example, by authorizing an interest rate between the lower contract rate and the higher market rate.[89] If the states or federal agencies fail to extend the grace period, due-on-sale clauses in window period loans will become enforceable at the end of the three year grace period.[90] The three year grace period does not apply to loans made by federally chartered savings and loans or savings banks,[91] or to loans made in states which had not restricted use of due-on-sale clauses.[92]

The issues remaining after *de la Cuesta* and passage of the Act are best articulated by dividing the affected loans into three groups: pre-regulation loans made by federal savings and loans, loans made by other lenders in states that had restricted use of the clauses, and loans made by other lenders in states that had not passed a statute or constitutional provision on due-on-sale or that did not have a court decision on the question of whether use of due-on-sale clauses should be restricted. For purposes of clarity, states that restricted use will be called declared states. States that had not confronted the issue will be called undeclared states. Pre-regulation loans made by federal savings and loans will be called pre-regulation loans. Loans made by lenders other than federal savings and loans will be called other lender loans.

This categorization reveals four groups of potential plaintiffs: parties with other lender loans from declared states, parties with other lender loans from undeclared states, parties with pre-regulation loans from declared states, and parties with pre-regulation loans from undeclared states. Although issues of whether contracts have been impaired or property has been taken are common to all four groups, these issues are most clearly present in the other lender declared group because the Act extinguishes rights explicitly guaranteed by the states.

The other three groups face threshold questions concerning whether they

[85] *Id.* § (c)(2)(c).

[86] *Id.* § (c)(1).

[87] History, *supra* note 4, at 22-24, U.S. CODE CONG. & AD. NEWS at 3076-78.

[88] 12 U.S.C. § 1701j-3(c)(1)(A), (B) (1982). The states may regulate loans originating from lenders other than federally chartered institutions. *Id.* § (c)(1)(A). The Comptroller of the Currency may regulate loans made by national banks. *Id.* § (c)(1)(B). And, the National Credit Union Administration Board may regulate loans made by federal credit unions. *Id.*

[89] History, *supra* note 4, at 23, U.S. CODE CONG. & AD. NEWS at 3077.

[90] 12 U.S.C. § 1701j-3(c)(1)(A), (B) (1982).

[91] *Id.* § (c)(2)(C).

[92] *Id.* § (c)(1).

had rights before the Act was passed.[93] Resolution of threshold questions of existence of rights for groups other than the other lender declared category is beyond the scope of this note. The existence of equitable rights of ownership and freedom from restraints on alienation or from unconscionable overreaching must be determined by state law. Whether state law was preempted by HOLA or by the 1945 regulation is a matter of preemption doctrine.

Consequently, this note examines the impairment and taking issues for the other lender declared group. Also, occasionally it examines what issues would arise if one of the other groups were able to establish preexisting rights.

IMPAIRMENT OF CONTRACT

Because it attaches new benefits and obligations to the mortgage contracts, the preemption of state due-on-sale law presents a classic problem of a retroactive statute.[94] Retroactive legislation traditionally has been regarded as undesirable because it reduces the possibility of planning conduct with reasonable certainty of the legal consequences[95] and creates uncertainty about past transactions.[96] Yet, because the law must change to meet new fact situations and new social values, prohibitions against retroactive laws can never be absolute.[97]

Constitutional protection against retroactive civil statutes is found in the contract clause, which provides that "no State shall . . . pass any . . . Law impairing the Obligation of Contracts."[98] and in the due process clause

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[93] Plaintiffs from the other lender undeclared group must establish that they had rights even though the state had not explicitly restricted the use of the clauses. These plaintiffs may point to case law supporting the doctrine that mortgagors retain all ownership interests in their property while mortgagees are limited to security interests and argue that the Act grants the mortgagee an ownership interest. *See supra* text accompanying notes 34-38. These plaintiffs further may argue that the Act extinguishes their equitable rights to be free from restraints on alienation or unconscionable overreaching. The lenders may argue that the Act confirms a preexisting but unaffirmed ownership interest. For plaintiffs from the pre-regulation declared group, *see* History, *supra* note 4, at 22 nn.2-5, U.S. CODE CONG. & AD. NEWS at 3076 nn.2-3 (for a list of states which restricted use before the 1976 regulation), the threshold question is when the Board's preemption occurred. If state law was preempted in 1933 by HOLA or in 1948 by the full protection regulation, 12 C.F.R. § 545.8-3(a) (1983), the Act did not extinguish pre-existing rights. Plaintiffs from the pre-regulation undeclared group face the double burden of proving that the Board did not preempt until 1976 and that their rights existed though undeclared.

[94] A statute is retroactive when it attempts to establish the legal significance of transactions that occurred before its enactment. Greenblatt, *Judicial Limitations on Retroactive Civil Legislation*, 51 NW. U.L. REV. 540, 544 (1956).

[95] Hochman, *The Supreme Court and the Constitutionality of Retroactive Legislation*, 73 HARV. L. REV. 692, 692-93 (1960).

[96] *Id.*

[97] *Id.*

[98] U.S. CONST. art. I., § 10, cl. 1.

of the fifth amendment,[99] which prohibits the federal government from depriving any person of property without due process of law.[100] The tension between reliability and flexibility has been reflected in the analysis of statutes under both clauses.[101] Although the contract clause is phrased in absolute terms, the states are not prevented from exercising their police powers by private contracts.[102] Traditionally, the balancing process under fifth amendment due process has appeared to be the same as that under the contract clause.[103] Although the Court's revival of the contract clause leaves the balancing process unclear, it does not suggest that the Court should differentiate its review under the two clauses.[104] This note, therefore, will analyze the retrospective aspects of due-on-sale preemption under the revived contract clause.

The Revived Contract Clause

There are three steps in the analysis of a statute under the revived contract clause.[105] First, the Court examines the severity of the impairment

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[99] U.S. CONST. amend. V. The fifth amendment provision that property shall not be taken for a public use without just compensation occasionally has been invoked to invalidate retroactive statutes, but the generally accepted view is that the takings clause only applies to direct appropriations of private property by the government. Hochman, *supra* note 95, at 694 n.15.

[100] Hochman, *supra* note 95, at 694.

[101] *Id.* at 694-95.

[102] Energy Reserves Group, Inc. v. Kansas Power & Light Co., 103 S. Ct. 697, 704 (1983); Schwartz, *Old Wine in Old Bottles? The Renaissance of the Contract Clause*, 1979 SUP. CT. REV. 95, 99-101.

[103] Hochman, *supra* note 95, at 695; Hale, *The Supreme Court and The Contract Clause: III*, 57 HARV. L. REV. 852, 890 (1944); Schwartz, *supra* note 102, at 121; *see* Usery v. Turner Elkhorn Mining Co., 428 U.S. 1, 16 (1976) (citing Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934) (a contract clause case in support of the proposition that the due process clause doesn't invalidate economic legislation solely because it upsets otherwise settled expectations.); United States Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 26 n.25 (1977) (noting that the same standard of review was employed when either a state or the federal government impaired its own contract.); Nachman Corp. v. Pension Ben. Guar. Corp., 446 U.S. 359, 367 n.12 (comparing federal impairment of contracts under ERISA to the state impairment in Allied Structural Steel Co. v. Spannaus, 438 U.S. 234 (1978)).

[104] Justice Brennan, the principal spokesman against the revival of the contract clause, argues that the Court has given a unified interpretation to the clauses which protects economic interests and that the Court, in Usery v. Turner Elkhorn Mining Co., 428 U.S. 1 (1976), adopted a deferential standard of review when evaluating a contract impairment under the due process clause. By reviving the contract clause, the Court has broken the unified interpretation. Brennan argues that the Court should restore the unified interpretation by returning to deferential review. He does not argue that the unified interpretation should be abandoned.

Futhermore, *Turner Elkhorn* may be reconcilable with the new contract clause review. Although Brennan characterized the review as deferential, the *Turner Elkhorn* Court explicitly noted that "[t]he retrospective aspects of legislation, as well as the prospective aspects, must meet the test of due process, and the justifications for the latter may not suffice for the former." 428 U.S. at 17. Moreover, the legislation in *Turner Elkhorn*, which imposed upon coal operators an obligation to compensate miners for death or total disability due to black lung disease, was broadly focused in contrast to the narrow aim of the statute struck in Allied Structural Steel v. Spannaus, 438 U.S. 234 (1978). *Turner Elkhorn*, therefore, may be reconcilable with the contract clause cases.

[105] Energy Reserves Group, Inc. v. Kansas Power & Light Co., 103 S. Ct. 697, 704-06 (1983).

caused by the change to determine whether judicial review should be invoked and, if it should, what level of scrutiny should be applied.[106] Minimal alterations of contractual obligations will not trigger review.[107] If the impairment is severe, however, the level of scrutiny will be heightened.[108] Second, if the Court finds that the impairment is sufficiently severe to warrant judicial review, it examines the justification for the statute to see if it meets a significant and legitimate public purpose.[109] The final inquiry is whether "the adjustment of 'the rights and responsibilities of contracting parties [is based] upon reasonable conditions and [is] of a character appropriate to the public purpose justifying [the legislation's] adoption.'"[110]

The first step, assessing the severity of the impairment, is directly related to the balance between allowing the parties to rely on their contracts[111] and allowing government to change the law.[112] Two concerns may be extracted from the Court's determination of severity: whether the lost benefit was a gain reasonably expected from the contract (the reasonable gains test);[113] and, whether it was reasonable for the contracting parties to rely on the continuing existence of the law (the reasonable reliance test).[114]

The standard for measuring an impairment under the reasonable gains test is whether the person asserting the right would have entered into the original transaction had he been able to foresee the subsequent legislation.[115] If the legislation takes from the contract the quality of an acceptable investment for a rational investor, the party, obviously, would not have entered into the contract; the legislation would be invalid under the contract clause.[116] If, however, the impaired benefit was not the central undertaking of the contract and did not induce the injured party to enter into the contract, the legislation impairing the benefit is valid.[117] The test, therefore, distinguishes between rights central to the contract and peripheral concerns.

The tension between reliance and flexibility is more directly expressed in the reasonable reliance test. When a contract is made in an area subject to the regulatory powers of the legislature, it necessarily is subject to the further exercise of the legislative powers.[118] To hold otherwise would allow the parties to remove their transactions from the control of the legislature

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[106] *Id.*
[107] Allied Structural Steel v. Spannaus, 438 U.S. 234, 246 (1978).
[108] *Id.*
[109] *Energy Reserves*, 103 S. Ct. at 705.
[110] *Id.* (quoting United States Trust v. New Jersey, 431 U.S. 14, 22 (1977)).
[111] *Energy Reserves*, 103 S. Ct. at 705.
[112] *Id.*
[113] *Id.*
[114] *Id.*
[115] Shelter Framing Corp. v. Carpenter's Pension Trust, 543 F. Supp. 1234, 1249 (C.D. Cal. 1982); Hochman, *supra* note 95, at 715.
[116] *See* W.B. Worthen Co. v. Kavanaugh, 295 U.S. 56, 60 (1935); Hochman, *supra* note 95, at 715.
[117] *See* City of El Paso v. Simmons, 379 U.S. 497, 515 (1965).
[118] Hochman, *supra* note 95, at 700.

by making a contract about them.[119] In the broadest reading of this principle, the reliance interests of the parties are not impaired because, when the contract was made, the parties were on notice that the legislature had competence in a given field, and that it may exercise its powers. Consequently, the parties suffer no unfair surprise when these powers are exercised retroactively.[120]

If the implied power of the government to regulate further was always given this broad protection, the contract and due process clauses would no longer protect reliance interests.[121] Under the broad reading, retroactivity would be immaterial in determining the constitutionality of a statute.[122] If the legislature could act prospectively, it could make the statute apply to past transactions.[123] The certainty required for planning conduct through contracts would be destroyed because the legislature might change the legal effect of past transactions at will.[124]

As applied, the test of reasonable reliance on the law protects against drastic and unexpected legislation. If a contract is expressly structured against a background of regulation, the parties have anticipated regulatory change and their expectations that there will be no further regulation would be both unreasonable and too intrusive on the power of the legislature.[125] When a contract does not expressly anticipate regulation, but impliedly incorporates existing law,[126] the courts must infer the expectations of the parties at the time of formation to determine whether the impact of the regulation is unexpected and drastic.

It is unclear from recent contract clause cases whether a regulation is unexpected because it regulates a particular subject not previously regulated or because it enters a general area not previously regulated. Both *Allied Structural Steel v. Spannaus*[127] and *Energy Reserves Group v. Kansas Power and Light*,[128] the most recent contract clause cases, rely on *Veix*

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[119] Hudson Water Co. v. McCarter, 209 U.S. 349, 357 (1908).

[120] Hochman, *supra* note 95, at 700.

[121] Pennsylvania Coal Co. v. Mahon, 260 U.S. 393, 413 (1922).

[122] Hochman, *supra* note 95, at 700.

[123] *Id.*

[124] *Id.* Another article points out that the broad reading would place complete reliance for the protection of property and contractual rights on the judgment of the legislature and argues that the Court should be the final arbiter of these rights because the legislature is more likely to be influenced by political forces and temporary expediencies. Under a process theory of the contract clause, the Court would limit its review to "whether the legislature made the judgment necessary to support the validity of the impairment and whether the political process functioned effectively to provide all interested parties with a fair opportunity to argue their cases or to challenge an adverse decision." Note, *A Process-Oriented Approach to the Contract Clause*, 89 YALE J.L. 1623, 1645 (1980). *See generally* Michelman, *Process and Property in Constitutional Theory*, 30 CLEV. ST. L. REV. 577 (1982); J. ELY, DEMOCRACY AND DISTRUST: A THEORY OF JUDICIAL REVIEW (1980).

[125] *Energy Reserves*, 103 S. Ct. at 707-08.

[126] *United States Trust*, 431 U.S. at 19 n.17.

[127] 438 U.S. 234 (1978).

[128] 103 S. Ct. 697 (1983).

v. Sixth Ward Building and Loan Ass'n[129] for the proposition that an expectation of no further regulation is unreasonable. In both *Veix* and *Energy Reserves* the particular subject had been previously regulated; in *Allied* it had not. It appears clear from *Allied* that a regulation in a previously unregulated area would be unexpected,[130] while *Veix* and *Energy Reserves* show that a regulation on a particular subject would be expected if both the area and the subject had previously been regulated.[131] What is not clear is whether a regulation would be expected if the particular subject had not been regulated but the area had.

The drastic element of the reasonable reliance test examines whether the change in the law changes an obligation in an area where reliance is vital.[132] An impairment is likely to be found to be drastic when the burdened party had relied on the contract terms to assess future liability, and the change imposed a completely unexpected liability in potentially disabling amounts without provision for gradual applicability.[133]

In summary, the inquiry into severity examines whether the impaired benefit was central to the contractual undertaking and examines whether the new regulation operates in a previously unregulated area or imposes potentially disabling liabilities. The second inquiry, whether the statute serves a significant and legitimate public purpose, guarantees that the state uses its power to remedy a broad and general social or economic problem rather than provide a benefit to special interests.[134] A statute may be suspected of serving special interests if there is no showing of legislative intent to meet an important general social problem,[135] if the focus of the legislation is extremely narrow,[136] or if the law deals only with private rights and not a legitimate public end.[137] The degree of deference given the legislative judgment in the final inquiry, which addresses the reasonableness and necessity of the legislation, also depends upon whether the state is a party to the contract. When a state is a party to a contract, complete deference to the legislature's judgment that the contract should be impaired is inappropriate because the state's self interest is involved.[138]

Although legislation impairing private contracts enjoys a presumption favoring the legislative judgment of reasonableness and necessity, the

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[129] 310 U.S. 32 (1940).

[130] *See Allied*, 438 U.S. at 234. It is unclear how much weight was given this factor in *Allied* because of the drastic nature of the impairment.

[131] *See Energy Reserves*, 103 S. Ct. at 697.

[132] *Shelter Framing*, 543 F. Supp. at 1251-52.

[133] *See Allied*, 438 U.S. at 247-49.

[134] *Energy Reserves*, 103 S. Ct. at 705.

[135] *Allied*, 438 U.S. at 248-49.

[136] *Id.*; Note, *supra* note 124, at 1631 n.46.

[137] Treigle v. Acme Homestead Ass'n, 297 U.S. 189, 197-98 (1936). *But see* Hochman, *supra* note 95, at 697 n.29 (noting that *Treigle* may be irreconcilable with Veix v. Sixth Ward Bldg. & Loan Ass'n, 310 U.S. 32 (1940)).

[138] *Energy Reserves*, 103 S. Ct. at 705 n.14.

presumption will not stand if the legislature is completely indifferent to the interests of the adversely affected parties.[139] To be reasonable and necessary, the legislation must have "limitations as to time, amount, circumstances, or need"[140] demonstrating an attempt to impose liability only to the extent necessary to achieve the legislative purpose.[141] Once this facial concern for the adversely affected parties has been shown, deference will be given to the means chosen.[142]

An Analysis of Due-on-Sale Preemption Using the Tests of the Revived Contract Clause

Although analysis of the retroactive aspects of due-on-sale preemption under the public purpose and reasonable and necessary tests suggests constitutionality, analysis of whether the impairment was severe is fact specific. The expansion of preemption to include plaintiffs from the other lender declared group may make the results of the impact text vary by time of loan, type of lender, and type of loan. Because of the complexity of the issues, this note uses residential mortgages as a means for its analysis.[143]

Analysis of the impact of retroactivity under the reasonable gains test, the first factor of the impact test, varies by time of loan. For loans made before use of the clauses was restricted, removal of the restriction reduces the borrower's gains to those reasonably expected from the contract. Before the rapid rise in interest rates, due-on-sale clauses were of peripheral concern to both parties. Borrowers expected the purchasers of their homes

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[139] In all contract clause cases decided after Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934), and including El Paso v. Simmons, 379 U.S. 497 (1965), the Court considered the degree to which the legislature sought to protect the interests of the adversely affected parties and struck legislation when the legislature was indifferent. Note, *Revival of the Contract Clause:* Allied Structural Steel Co. v. Spannaus *and* United States Trust v. New Jersey, 65 VA. L. REV. 377, 399 (1979). The Court did not decide any contract clause cases after *El Paso* until *United States Trust.* The concern for the adversely affected parties reappeared in *United States Trust* and *Allied.* The *United States Trust* opinion noted that "the State has made no effort to compensate the bondholders for any loss sustained by the repeal . . . nor was the covenant merely modified or replaced by an arguably comparable security provision. Its outright repeal totally eliminated an important security provision . . . ." 431 U.S. at 19. The *Allied* opinion stressed the adverse impact the statute would have on Allied while failing to moderate the impact. "The effect of [the Minnesota statute] on this contractual obligation was severe . . . . [T]he statute in question here nullifies express terms of the company's contractual obligations and imposes a completely unexpected liability in potentially disabling amounts. There is not even any provision for gradual applicability or grace periods." 438 U.S. at 246-47. Federal impairment of contracts in enacting ERISA, was acceptable because Congress demonstrated concern for the adversely affected parties. Nachman Corp. v. Pension Ben. Guar. Corp., 446 U.S. 359, 367-68 n.12 (1980).

[140] *W.B. Worthen*, 292 U.S. at 434.

[141] *Nachman*, 446 U.S. at 368 n.12.

[142] *Allied*, 438 U.S. at 248.

[143] The analysis of the parties' expectations is based upon the expectation of the lenders that the loans would not be outstanding for their full term. *See* ECONOMIC ANALYSIS, *supra* note 13, at 7.

to refinance; lenders expected borrowers to pay off the mortgage before the term expired.[144] Neither party anticipated the borrower becoming the financier of future sales or the lender invoking the clause to force refinancing.[145] The extra gain the borrower received from allowing assumption, therefore, was an unforeseen windfall profit, whose elimination is reasonable under the contract clause.[146] For mortgages entered into after invalidation, the potential gain received from assumption is not a windfall profit. To avoid losses caused by longer term mortgages, lenders may have increased the interest rates of their mortgages.[147] If the interest rates were adjusted, the profit from future assumptions was paid by the borrower. Removal of the restrictions on enforcement, therefore, gives the lender a windfall and takes from the borrower a gain reasonably to be expected from the contract.

In determining reasonable reliance, the second subtest of impact, analysis of whether the removal of restraint was unexpected is less clear than analysis of whether the removal was drastic. Whether preemption should have been anticipated depends upon the Supreme Court's interpretation of prior regulation. If the Court intends prior regulation to mean regulation of a particular subject, preemption is unexpected. The federal government has not regulated acceleration clauses. If prior regulation includes regulation of an area, even though the particular subject has not been regulated, preemption should have been expected. Although mortgages are traditionally thought of as a matter of state property law subject to equitable defenses,[148] the federal government has taken an increasing role by regulating lending practices and insuring loans.

Several federal laws have added requirements which must be fulfilled by mortgage lenders.[149] The Truth-in-Lending Act[150] requires lenders to disclose interest and finance charges. The Fair Housing Act[151] prohibits discrimination on the basis of race or sex. The Real Estate Settlement Procedures Act[152] requires disclosures concerning settlement costs and approved closing statements, and prohibits certain types of kickbacks between mortgage lenders and other providers of settlement services. The Home Mortgage Disclosure Act[153] requires institutional lenders to assemble and

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[144] *Id.*

[145] Cassidy, *supra* note 7, at 35.

[146] *See supra* text accompanying notes 114-18.

[147] *See* Cassidy, *supra* note 7; *see* Dietrich, *supra* note 25. *But see* Cassidy, *supra* note 7, at 36 n.1.

[148] *See supra* text accompanying notes 31-42.

[149] Earthman, *Residential Mortgage Lending: Charting a Course Through the Regulatory Maze,* 29 VAND. L. REV. 957, 969-80 (1976).

[150] 15 U.S.C. §§ 1601-1666j (1982).

[151] 42 U.S.C. §§ 3601-19, 3631 (1982).

[152] 12 U.S.C. §§ 2601, 2602-04, 2607, 2609, 2616, 2617 (Supp. I 1976).

[153] 12 U.S.C. §§ 2801-09 (1982).

release to the public data on the amounts and locations of their residential loans.

Notice of future regulation of mortgages by the federal government also may be found in preemption of state debtor protection laws when the United States, through one of its mortgage insurance programs, is a plaintiff as the holder and forecloser of a mortgage.[154] Courts have found that debtor protection laws which impose financial burdens on lenders are preempted by federal law because they frustrate both "the federal policy to protect the treasury and to promote the security of the federal investment"[155] and the purpose of the federal programs which is "to facilitate the building of homes by the use of federal credit."[156] Although the previous preemption controversy which surrounded due-on-sale clauses was limited to federal savings and loans,[157] the preemption doctrine that emerged from cases in which the United States was a plaintiff was not limited to federal savings and loans and may be construed as notice to all borrowers that debtor protection laws, such as due-on-sale restrictions, could be superceded by the needs of the federal government.

Plaintiffs with pre-regulation loans from federal savings and loans may find the prior regulation obstacle impossible to hurdle. As the Court noted in *Fidelity Federal Savings and Loan v. de la Cuesta,* the Federal Home Loan Bank Board was given the authority to regulate the thrift's lending practices by HOLA, and has used this authority extensively including, in particular, regulation of the terms of loan instruments.[158] Because of this long and extensive history of particular regulation, pre-regulation plaintiffs have little chance of showing that preemption was unexpected.

Whether the Court would view the impact of due-on-sale preemption as severe depends not only upon prior regulation, but also upon whether the regulation imposes a drastic new burden. In *Allied Structural Steel v. Spannaus* the plaintiff relied on existing law to determine future liability in funding a pension plan.[159] Passage of the state law, which retroactively imposed

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[154] *See* Note, *Federal Housing Loans: Is State Mortgage Law Preempted?*, 19 SANTA CLARA L. REV. 431 (1979); *see also* Bartlett, *The Federal-State Preemption Conflict*, 44 LEGAL BULL. 1 (1978).

[155] Note, *supra* note 154, at 439 (quoting U.S. v. View Crest Garden Apts. Inc., 268 F.2d 380, 383 (9th Cir.), *cert. denied*, 361 U.S. 884 (1959)).

[156] *Id.* In United States v. Yazell, 382 U.S. 341 (1966), the Supreme Court appears to have narrowed this preemption rule. Although the Court relied on the fact that the parties had bargained for a state choice of law clause, the Court's principal rationale involved a weighing of the respective interests of the state and federal governments. OSBORNE, NELSON & WHITMAN, REAL ESTATE FINANCE LAW 698 (1979). While the federal government's interest in collecting money more quickly may not be sufficient to override state debtor protection law, other federal interests may be sufficient. *Id.* at 700-01.

[157] *See generally* Sanders, *"Due-on-Sale" Clauses: Are They Enforceable in Florida?*, 54 FLA. B.J. 679 (1980); Note, *A Case for Preemption:* Wellenkamp v. Bank of America *is Inapplicable to Federal Savings and Loan Associations*, 20 SANTA CLARA L. REV. 219 (1980).

[158] Fidelity Federal Sav. & Loan Ass'n v. de la Cuesta, 102 S. Ct. 3014, 3029 n.20 (1982).

[159] Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 240, 246 (1978).

a vesting requirement of pension benefits covering a ten year period, left the plaintiff with potentially devastating contractual obligations.[160] Although plaintiffs affected by the preemption of due-on-sale restrictions have lost an economically advantageous aspect of their contracts,[161] preemption does not impose an additional obligation or have an economic impact as drastic as that in *Allied.*

Analysis under the public purpose test is more straightforeward than under the severity test. Extending the preemption of due-on-sale restrictions to other lenders serves a public purpose. Due-on-sale restrictions cause buyers to pay an inflated price for an existing home with a lower rate assumable loan.[162] Also, the restrictions force lenders to charge a premium for new loans to offset losses from old loans[163] and to cover risks incurred by longer term loans.[164] Due-on-sale restrictions encourage default because the purchase price of the home is inflated to reflect the preferential terms that the parties attribute to the assumable loan, thus increasing the buyer's nominal liabilities relative to the underlying market value.[165] When the buyer must refinance, typically in five years, the underlying value may be insufficient.[166] Due-on-sale restrictions also increase defaults by encouraging transactions outside of the established market.[167] Nonmarket transactions are more likely to end in default because the parties are inexperienced at valuing the property and are more likely to agree upon values and financing costs that are out of line with the underlying risks borne by them.[168] Due-on-sale restrictions discourage the use of roll-over and variable rate mortgages.[169] In addition, by extending preemption to all lenders, the Act removes a competitive advantage from the federal savings and loans.[170]

The most important public purpose served by the Act is the relief it gives to the savings and loan industry. The industry, whose primary function is to finance the purchase of construction of housing,[171] is crucial to the nation's credit system.[172] Restrictions on the use of due-on-sale clauses adversely affect the thrifts in two ways. First, prohibiting the use of due-on-sale clauses to update portfolios produces a slowdown in prepayment cash flows which might reduce the ability of the thrifts to make new mortgage loans.[173]

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[160] *Id.* at 247-48.
[161] ECONOMIC ANALYSIS, *supra* note 13, at 5.
[162] *Id.*
[163] Dietrich, *supra* note 25, at 25.
[164] *Id.* at 20.
[165] *Id.* at 25.
[166] *Id.* at 27.
[167] *Id.* at 31.
[168] *Id.*
[169] ECONOMIC ANALYSIS, *supra* note 13, at 17.
[170] History, *supra* note 4, at 21, U.S. CODE CONG. & AD. NEWS at 3075.
[171] WHITE, TEACHING MATERIALS ON BANKING LAW 41 (1976).
[172] Veix v. Sixth Ward Bldg. & Loan Ass'n, 310 U.S. 32, 37 (1940).
[173] Cassidy, *supra* note 7, at 25.

Second, the invalidation erodes the market value of the thrift's mortgage portfolios, potentially impairing their capital position.[174] The economic viability of the savings and loan industry clearly is aided by removing restraints on due-on-sale enforcement.

The last step of the contract clause analysis, the reasonable and necessary test, is a least intrusive means analysis which requires the legislature to demonstrate that it attempted to impose liability only to the extent necessary to achieve the public purpose.[175] Limited intrusiveness is found in "limitations as to time, amount, circumstances [and] need."[176] Legislation impairing private contracts enjoys a presumption favoring the legislative judgment of the reasonableness and necessity of the measure.[177] Congress attempted to moderate the impact of due-on-sale enforcement on homeowners in non-enforcement jurisdictions in several ways: by providing a three year grace period before their rights were preempted,[178] by placing restrictions on the type of transfers that could trigger invocation of the due-on-sale clause,[179] by encouraging lenders to accept assumption at the old interest rate or at a rate below the current market rate,[180] and by prohibiting the retroactive enforcement of due-on-sale clauses for property sales that took place before the legislation was enacted.[181] Although this facial concern for the impact of the legislation on adversely affected parties supports the presumption in favor of validity to stand, it is instructive to consider weaknesses in the offered protection.

The relief provided by the three year grace period may be illusory. Although the mortgages would continue to be regulated by state law during that period, the states and other regulatory bodies are authorized to change the law by repealing existing due-on-sale restrictions, by lengthening the grace period, or by authorizing below market rates for assumptions of these loans.[182] Because the states and regulatory agencies are free to act, the homeowner cannot rely on the continued existence of rights during the grace period.

Unlike the grace period contemplated by the Supreme Court in *Allied*, during which the insurer could adjust for the obligation by changing its funding practices, there is little the homeowner can do during the grace period to minimize the impact of the due-on-sale legislation on his interests. The homeowner, knowing that in three years he will not be able to sell his home for an inflated price, has two options: to sell now or to increase

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[174] *Id.* The loss on the book value of California savings and loans in 1978 due to the invalidation of the clauses has been estimated to have been the equivalent of 45% of their net worth. *Id.*

[175] *See supra* text accompanying notes 138-42.

[176] W.B. Worthen v. Thomas, 292 U.S. 426, 434 (1934).

[177] Energy Reserves Group, Inc. v. Kansas Power & Light Co., 103 S. Ct. 697, 706 (1983).

[178] 12 U.S.C. § 1701j-3(c)(1) (1982).

[179] *Id.* § 1701j-3(d).

[180] History, *supra* note 4, at 21, U.S. CODE CONG. & AD. NEWS at 3075.

[181] 12 U.S.C. § 1701j-3(c)(2)(B) (1982).

[182] *Id.* § (c)(1)(A).

savings so that he will have available at the time he enters the housing market the funds he might have obtained by selling his below market interest rate.

Encouragement of below market interest rates provides little protection to homeowners. Below market rates benefit all parties to the transaction by allowing lenders to increase interest income on older loans, by facilitating sale, and by providing affordable rates to buyers. Encouraging below market rates, however, is illusory protection because it is nonmandatory.

The limitations on enforcement were not particularly designed to moderate the impact of the Act on homeowners in nonenforcement jurisdictions. Drawn from a Federal Home Loan Bank Board regulation,[183] the limitations are a general consumer protection measure and are not an attempt to ameliorate the impact of due-on-sale preemption on the nonenforcement class. Also, the prohibition on retroactive enforcement may have been motivated more by a desire to avoid other serious constitutional problems than by a desire to lessen impact on homeowners. If retroactive enforcement had been allowed, affected homeowners easily could have shown that the expectation of validity was of central concern at the time of sale and that invalidation of the transaction would place on the parties drastic, new obligations equivalent to those in *Allied.* If the purpose of prohibiting retroactivity was to avoid a separate constitutional problem, it may not be used as evidence of amelioration.

In sum, examination of the extension of preemption using the tests of the revived contract clause shows that a serious constitutional challenge may be raised only by plaintiffs who entered into their contracts after the use of due-on-sale clauses was restricted. The success of the challenge depends upon how the Court interprets prior regulation and weighs the severity of the impact against the clear public purpose and facially valid, though weak, least intrusive means. Because the extension serves important public goals, the borrower's interests are clearly outweighed.

JUST COMPENSATION

Although the fifth amendment's prohibition against taking property without just compensation is expressed in absolute terms,[184] government could not function if it was forced to pay for every decrease in property value caused by its regulations.[185] Just compensation analysis concerns the tension in allowing government freedom to respond to change without rendering the just compensation clause meaningless.[186]

[183] 12 C.F.R. § 545.8-3(g) (1983).

[184] "nor shall private property be taken for public use without just compensation." U.S. CONST. amend. V.

[185] Pennsylvania Coal Co. v. Mahon, 260 U.S. 393, 413 (1922).

[186] Note, *Balancing Private Loss Against Public Gain to Test for a Violation of Due Process or a Taking Without Just Compensation,* 54 WASH. L. REV. 315, 321 (1979).

The central principle behind the just compensation clause is that "[g]overnment [should not] forc[e] some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole."[187] As a limit on the government power to isolate particular individuals for sacrifice to the public good, just compensation analysis contains a distributive choice similar to that of torts law: the choice between "(1)leaving the harm where the government action initially imposed it, and (2)taking steps to spread the harm more widely or at least differently."[188] If a court determines that fairness requires that the costs should not be borne by the individual alone, the law will be invalidated for failure to pay just compensation.

Courts and commentators have been unable to articulate a single, simple test to determine when a government regulation results in a taking.[189] The Supreme Court's analysis of whether compensation is required is essentially an ad hoc factual inquiry.[190] If the regulation passes the threshold requirement of substantially advancing a legitimate state interest,[191] the Court has considered the character of the government action, its economic impact, and its interference with reasonable investment-backed expectations.[192] The legitimate state interest factor is similar to the public purpose test of the contract clause because both analyses invalidate laws that fail to advance a legitimate public goal.[193] Character of government action refers to physical invasion by the government.[194] Because the extension of due-on-sale preemption serves a public purpose and does not involve a physical invasion by the government, the just compensation analysis centers on economic impact and interference with reasonable investment-backed expectations.

If the Court considers economic impact as distinct from interference with investment-backed expectations,[195] this test is analytically troublesome. In

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[187] Penn. Cent. Transp. Co. v. City of New York, 438 U.S. 104, 124 (1978) (quoting Armstrong v. United States, 364 U.S. 40, 49 (1960)).

[188] TRIBE, AMERICAN CONSTITUTIONAL LAW 464 (1978); *accord* Michelman, *Property, Utility and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165, 1169 (1967).

[189] Allied Structural Steel v. Spannaus 438 U.S. 234 (1978).

[190] *Id.*

[191] Agins v. City of Tiburon, 447 U.S. 255, 261 (1980).

[192] Pruneyard Shopping Center v. Robins, 447 U.S. 74, 84 (1980).

[193] *See supra* text accompanying notes 134-37. The legitimate state interest test is derived from Nectow v. Cambridge, 277 U.S. 183 (1928). In *Nectow*, a local zoning ordinance deprived a landowner of all practical uses of his land. The Supreme Court invalidated the regulation not only because it prevented an adequate return on the investment for the development of the property, but also because it failed to promote the health, safety, convenience, or public welfare of the public. 277 U.S. at 187-88.

[194] *Penn. Central*, 438 U.S. at 125; Loretto v. Teleprompter Manhatten CATV Corp., 102 S. Ct. 3164, 3175 (1982).

[195] Although the *Penn. Central* opinion appeared to consider the two factors together ("economic impact of the regulation . . . and particularly, the extent to which the regulation has interfered with distinct investment-backed expectations . . . ." 438 U.S. at 124) subsequent opinions appear to list them as separate factors. *See Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979); *Pruneyard*, 447 U.S. at 84.

Pennsylvania Coal Co. v. Mahon,[196] Justice Holmes promulgated the theory that, while economic values may be diminished somewhat without compensation, they may not be diminished excessively.[197] The test is difficult to apply because it calls for an arbitrary pinpointing of a critical amount of loss.[198] Furthermore, the Court has begun to recharacterize *Pennsylvania Coal*.[199] Rather than cite the case as an example of commercial impracticability with "nearly the same effect as the complete destruction"[200] of the leased property rights, the Court now describes the case as a "loss of a profit opportunity . . . accompanied by a physical restriction against the removal of the coal."[201] Similarly, loss of the most profitable use has been found not to be a taking when unaccompanied by physical invasion.[202] The Court, therefore, while influenced by economic impact, does not recognize a taking based on economic impact alone.[203]

More analytically useful is the reasonable investment-backed expectation test.[204] Based on a property expectation concept, this test requires compensation if the government interferes with a sufficiently important or fundamental expectancy reasonably held by private parties.[205] The reasonableness of the expectation depends upon whether the holder had prior warning that his expectation was inconsistent with the expectation of another party.[206] Compensation is not required if society adequately has made it known that the activity should not become a source for expectations of continuing enjoyment.[207] For example, if an investor buys scenic land during the height of public discussion about restricting its use, he should not be paid the difference between the land's value without restrictions and the value of the land with the restrictions should they be adopted. The price of the land should have been discounted by the possibility that the restrictions would be imposed. The investor, therefore, has received what he paid for, and compensation is not due.[208] The reasonableness aspect of the investment-backed expectations test, therefore, denies compensation for investments that society has designated should not be the object of expectations of continuing enjoyment.[209] The test, therefore, is similar

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196 260 U.S. 393, 413 (1922).
197 *Id.*
198 Michelman, *supra* note 188, at 1233.
199 Va. Surface Min. & Reclamation Ass'n, Inc. v. Andrus, 483 F. Supp. 425, 439 (W.D. Va. 1980).
200 *Id.* (quoting *Penn. Central*, 438 U.S. at 127).
201 *Id.* (quoting Andrus v. Allard, 444 U.S. 51, 66 n.22 (1979)).
202 *Allard*, 444 U.S. at 66.
203 *See id.*
204 Michelman, *supra* note 188, argues that the Court actually has been applying the reasonable investment-backed expectation test when analyzing diminution in value.
205 *Kaiser Aetna*, 444 U.S. at 179-80.
206 Michelman, *supra* note 188, at 1235-45.
207 *Id.* at 1241.
208 *Id.* at 1238.
209 *Id.* at 1241.

to the reasonable reliance test of the contract clause.[210] If the party is on notice that his property interest is subject to regulation, an investment based on an expectation of no change is unreasonable.

Not all reasonable expectations are entitled to compensation if destroyed by government regulations. In deciding whether a particular governmental action has effected a taking, the Supreme Court has focused on the nature and extent of interference with rights in the property as a whole.[211] If the property owner owns nothing of consequence after the regulation, the regulation interfered with a reasonable investment-backed expectation.[212] When the regulation does not involve physical occupation or invasion,[213] destruction of one use is not a taking so long as the owner is left with other uses.[214]

Just Compensation and Due-on-Sale

A taking analysis begins with the indentification of the impaired property interest. Property "denote[s] the group of rights inhering in the citizen's relation to the physical thing, as the right to possess, use and dispose of it."[215] Enforcement of due-on-sale restricts the owner's ability to sell and decreases future profits.[216] The loss of this property interest receives a two-step analysis under the takings clause: whether the expectation was reasonable, and whether it was an investment-backed expectation. However, as a preliminary matter, the three year grace period[217] of the due-on-sale preemption must be distinguished from a statute of limitation. If the grace period were a permissible statute of limitation, the takings issue would not arise.

The legitimating characteristic of a statute of limitation is the opportunity afforded the party to establish his rights in court.[218] Absent this opportunity, a statute bars existing rights arbitrarily.[219] An example of a grace period that is an acceptable statute of limitations may be found in *Texaco v. Short.*[220] An Indiana statute provided that a mineral lease not used for twenty years would expire unless the owner filed a proper claim with the county recorder. The statute also included, however, a two year grace period during which the owner could act before the expiration of the lease became effective.

[210] *See supra* text accompanying notes at 120-36.
[211] *Allard*, 444 U.S. at 66-67.
[212] Michelman, *supra* note 188, at 1234; *Penn. Central*, 438 U.S. at 128-29.
[213] The distinction between occupations and invasions was emphasized in *Loretto*, 102 S. Ct. at 3171-77.
[214] *See Allard*, 444 U.S. at 67.
[215] *Penn. Central*, 438 U.S. at 142-43 (Rehnquist, J., dissenting).
[216] *See supra* text accompanying notes 38-42.
[217] 12 U.S.C. § 1701j-3(c)(1) (1982).
[218] Wilson v. Iseminger, 185 U.S. 55, 62-63 (1902).
[219] *Id.*
[220] 102 S. Ct. 781 (1982).

The Supreme Court held that the grace period was permissible because the state had the power to condition the retention of the property right upon the performance of an act within a limited period of time.[221]

Unlike the Indiana statute, preemption of due-on-sale does not allow the owner to retain his property interest by the performance of an act, such as recording; the right unconditionally disappears at the end of the grace period. The three year grace period, which bars existing rights arbitrarily, merely postpones the taking. The taking issue, therefore, must be addressed.

The analysis of whether an expectation of continuing enjoyment of due-on-sale restrictions was reasonable involves the same problems inherent in analyzing reasonable reliance under the contract clause.[222] It is unclear whether the mortgagor should have anticipated preemption. If the Court would restrict notice to the particular area of acceleration clauses, it is reasonable for a mortgagor from the other lender declared group to rely on state guaranteed rights to sell without invoking the clause.[223] If the Court were to find notice in the regulation of lenders and the preemption controversy surrounding the United States as plaintiff cases, such reliance would not be reasonable.[224]

Even if the Court finds that reliance was reasonable, interference with the expectation is not compensable. While the enforcement of due-on-sale clauses causes a loss of future profits, the significance of this loss must be considered in light of the owner's retention of all other rights.

Loss of future profits as the only interest taken did not support a taking in *Andrus v. Allard*.[225] Dealers in Indian artifacts containing eagle feathers challenged regulations promulgated under the Eagle Protection Acts and the Migratory Bird Treaty Act, which forbid sale of the relics but did allow their possession or transportation.[226] The dealers argued that the prohibition deprived them of the opportunity to earn a profit from their relics and was an uncompensated taking.[227] The Court agreed that the regulations deprived the plaintiffs of the most profitable use of their property but stressed that they were still able to derive an economic benefit.[228] Loss of future profits, unaccompanied by any physical property restriction, could not support a taking because "[p]rediction of profitability is essentially a matter of reasoned speculation that courts are not especially competent to perform. Further, perhaps because of its very uncertainty, the interest

[221] *Id.* at 791.
[222] *See supra* text accompanying notes at 147-58.
[223] *Id.*
[224] *Id.*
[225] 444 U.S. 51, 64-68 (1979).
[226] *Id.* at 53-54.
[227] *Id.* at 64.
[228] *Id.* at 66.

in anticipated gains has traditionally been viewed as less compelling than other property-related interests."[229]

Preemption of due-on-sale restrictions causes less severe interference with expectations than the regulations in *Allard;* there is no absolute prohibition of sale and the most profitable use is not denied. Preemption, therefore, is not compensable under the takings clause.

CONCLUSION

Although borrowers may have reasonably relied on the continued existence of state restrictions on due-on-sale enforcement, their expectations are not protected by the due process and takings clauses. The important public purposes accomplished by the extension clearly outweigh the borrowers' expectations of future profits.

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[229] *Id.* The test is, of course, somewhat disingenuous since future profits in many instances are the sole determinant of present value. The test may have been prompted by the Court's desire to preserve the effectiveness of the Acts. The plaintiffs had shown that the feathers in their relics were obtained before passage of the Acts. The Court may have feared that, if pre-Act feathers were exempted from the Acts, the prohibitions of the Acts too easily could have been avoided by claiming that the seized feathers were obtained before passage.